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Staci Flinchbaugh

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“SLICING A SHADOW”¹: THE DEBATE OVER COMBINED REPORTING AND ITS EFFECT ON WISCONSIN’S BUSINESS CLIMATE

I. INTRODUCTION

A recent dispute² between the Wisconsin Department of Revenue and Wal-Mart Stores, Inc. over whether Wal-Mart’s business structure is in fact a tax avoidance strategy brought a familiar debate to the surface yet again: should Wisconsin adopt combined reporting?³ The case for combined reporting seems simple: corporations doing business in Wisconsin would be forced to pay their fair share of taxes to Wisconsin. However, as the Supreme Court has noted, “[a]llocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow.”⁴

In 2007, the State of Wisconsin began to take notice of the way Wal-Mart structures itself within Wisconsin borders.⁵ Although Wisconsin’s largest private employer⁶ paid \$36.8 million in state and local taxes in Wisconsin in 2008,⁷ the State believes it should be paying more.⁸ However, Wal-Mart is not the only corporation arguably paying less than its fair share of state taxes. Through a combination of tax avoidance strategies, deductions, and incentives, companies doing business in Wisconsin are avoiding the responsibility of helping support valuable state and local public services, leaving the burden with individuals. In 2005, close to 50,000 corporations filed returns in Wisconsin, and two-thirds of those returns “showed a bottom-

1. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 192 (1983).

2. See, e.g., Steven Walters & Avrum D. Lank, *Wal-Mart Owes Back Taxes, State Says: Paying Rent to Itself Cuts Millions off Retailer’s Tax Bill*, MILWAUKEE J. SENTINEL, Aug. 26, 2007, at A1.

3. Under a combined reporting regime, taxes are computed by treating all members of a unitary business as one, i.e., the corporate structure is ignored. See *infra* Part II.A.

4. *Container Corp.*, 463 U.S. at 192.

5. See Walters & Lank, *supra* note 2. An article that appeared on the front page of the *Wall Street Journal* in February of 2007 discussing North Carolina’s fight to close the same loophole that Wal-Mart is utilizing in Wisconsin possibly motivated the Department of Revenue’s action. Jesse Drucker, *Friendly Landlord: Wal-Mart Cuts Taxes By Paying Rent To Itself—Other Retailers, Banks Use Loophole in Rules to Lower States’ Levies*, WALL ST. J., Feb. 1, 2007, at A1.

6. Walters & Lank, *supra* note 2. Wal-Mart currently employs 30,097 Wisconsin residents in 58 Supercenters, 25 discount stores, 12 Sam’s Clubs, and 3 distribution centers. Wal-Mart State-by-State Information, <http://walmartstores.com/FactsNews/StateByState/State.aspx?id=48> (last visited May 28, 2009).

7. Wal-Mart State-by-State Information, *supra* note 6.

8. See Walters & Lank, *supra* note 2. The Department of Revenue sought \$17.7 million in back taxes, interest, and penalties for tax years 1998, 1999, and 2000. *Id.*

line tax of zero dollars.”⁹ As the Institute for Wisconsin’s Future puts it, “[i]t makes no sense . . . to have a tax system in which individual companies are able to choose as a matter of internal strategy whether or not to pay taxes.”¹⁰

As with most things in life, adopting combined reporting as a solution to tax avoidance is not as simple as it seems. There are various considerations that any state proposing a change to its tax structure must keep in mind. The focus of this Comment is the current state of the business climate in Wisconsin and how much impact the business climate rankings should have on discussing a change to the state tax structure given the faults of the structure currently in place. Part II.A will discuss the meaning of combined reporting. Part II.B will analyze the Department of Revenue’s case against Wal-Mart as well as other similar tax avoidance strategies that have been utilized in Wisconsin. Part II.C will focus on the current state of Wisconsin’s business climate, the various rankings, and what effect the rankings should have on the decision to locate a business within Wisconsin’s borders.

Part III of this Comment will analyze Wisconsin’s three available options for combating the most common tax avoidance strategies: attacking each tax avoidance scheme individually, passing legislation targeted at specific tax avoidance schemes, and adopting combined reporting. Finally, Part IV will conclude that Wisconsin should seriously consider adopting combined reporting, as it is the most effective method for combating the various tax avoidance strategies, and it will help, not hurt, the business climate in the long run.

II. A PRIMER ON COMBINED REPORTING AND TAX AVOIDANCE STRATEGIES IN WISCONSIN

A. *What is Combined Reporting?*

The three approaches currently used by states in determining corporate taxable income are separate accounting, formulary apportionment, and combined reporting.¹¹ Separate accounting treats each corporate entity as a separate taxable entity, regardless of the interconnectedness of its dealings with a parent or subsidiary.¹² It is “based on the premise that it is both

9. INST. FOR WIS.’S FUTURE, WISCONSIN’S REVENUE GAP: AN ANALYSIS OF CORPORATE TAX AVOIDANCE 1 (2007).

10. *Id.* at 12.

11. Richard D. Pomp, *State Tax Reform: Proposals for Wisconsin*, 88 MARQ. L. REV. 45, 49 (2004).

12. *Id.* at 53; see also Richard D. Pomp, *The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer*, in THE FUTURE OF STATE TAXATION 49, 60 (David Brunori ed., 1998) (defining separate entity states as “[s]tates that calculate the taxable income and

possible and practical to isolate the taxable income of portions of the business that a corporation carries on within a state.”¹³ Dealings between subsidiaries of the same parent company are treated as transactions between unrelated parties. If Company A, a subsidiary of Parent Company, manufactures Good X and delivers it to Company B, another subsidiary of Parent Company, a hypothetical arm’s length sales price, or transfer price, will need to be determined for tax purposes.¹⁴

Separate accounting is not practical. As the above transfer pricing illustration shows, determining a corporation’s sales proceeds based on hypothetical prices or, as is common, by determining the price at which manufacturers sell comparable goods to independent distributors can be administratively difficult.¹⁵ Furthermore, the number may not reflect the actual proceeds or profitability of the corporation, especially when that figure depends on activities that are integrated with subsidiaries of the same parent.¹⁶ The value of being part of a large synergistic operation cannot be fully conveyed through transfer prices.¹⁷

Formulary apportionment and combined reporting were developed in response to the inherent problems with separate accounting.¹⁸ The current system in place in Wisconsin is formulary apportionment, which works as follows: each company uses a formula to determine the percentage that should be apportioned to the company’s in-state activities or “presence.”¹⁹ First, the company uses Wisconsin law to compute its worldwide taxable income, which is the company’s pre-apportionment tax base.²⁰ Next, the company determines its apportionment percentage—an equation based on the company’s sales, payroll, and property located in Wisconsin compared with

apportionment percentage of the parent and ignore the taxable income and factors of the subsidiary, with which they have no connection or nexus”).

13. Pomp, *supra* note 11, at 49.

14. *Id.* at 50.

15. *Id.*

16. *See id.*

17. *See id.* at 50–51.

18. *Id.* at 49.

19. *Id.* at 51–52. Wisconsin’s system of apportionment was upheld by the United States Supreme Court in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 229–30 (1980). Against Exxon Corporation’s argument that it did not have a sufficient nexus with Wisconsin to permit Wisconsin to include all of Exxon’s net income in the apportionment formula, the Court reiterated its long-held belief that “‘the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs.’” *Id.* at 219 (quoting *Nw. States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959)).

20. WIS. STAT. § 71.25(5)(a) (2007–2008); Pomp, *supra* note 11, at 52.

the same factors on a worldwide basis.²¹ Finally, the taxable income of the corporation apportioned to Wisconsin is determined by multiplying its worldwide taxable income by the apportionment percentage.²²

Implicit in the adoption of formulary apportionment is the belief that determining a corporation's taxable income based on sales, payroll, and property is the superior method.²³ Combined reporting is merely an extension of that belief.²⁴ "The central element of [the case for combined reporting] is that the substance of the business activities in the state should control, not the organizational structure of the business entity or entities conducting those activities."²⁵

Combined reporting is a tax regime used in almost half of the states and is being considered in several others.²⁶ Under a combined reporting taxation system, taxes are determined on the parent company level; in other words, corporate structure is ignored. The parent company and its subsidiaries are all treated as if they are part of the same unitary business.²⁷

For accounting purposes, a combined report is a "document prepared on behalf of a group of corporations engaged in a unitary business."²⁸ The first step in compiling a combined report is to determine the scope of the unitary business (i.e., the parent company and its subsidiaries) to determine the group's aggregate taxable income.²⁹ Once the aggregate taxable income is

21. Wisconsin Department of Revenue Form 4B: Wisconsin Apportionment Data lays out the apportionment formula, which includes a double-weighted sales factor. Form 4B can be accessed on the Department of Revenue's website at <http://www.dor.state.wi.us/forms/2008/08ic-043.pdf>.

22. *Id.*; see also Pomp, *supra* note 11, at 52.

23. Pomp, *supra* note 11, at 52.

24. *Id.*

25. *Id.* at 53.

26. Avrum D. Lank, *Lawmakers Weigh Change in Business Taxes; Combined Reporting Could Bring in Millions*, MILWAUKEE J. SENTINEL, Sept., 22, 2007, at D1. The states that have adopted combined reporting so far are Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Ohio, Oregon, Texas, Utah, Vermont, and West Virginia. See MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, STATE CORPORATE TAX SHELTERS AND THE NEED FOR "COMBINED REPORTING" 5 n.1 (2007), available at <http://www.cbpp.org/files/10-26-07sfp.pdf>; ROBERT M. NACKER, WIS. ECON. DEV. INST., WHITHER COMBINED REPORTING—AN ECONOMIC VIEWPOINT 5 tbl.1 (2008), available at http://www.weda.org/about/legislative/pdf/WEDA_Combined_Reporting_02_20_08_Final.pdf. Additionally, adopting combined reporting has been considered by Iowa, Maryland, Massachusetts, New Mexico, North Carolina, and Pennsylvania. *Id.*; Giles Sutton & Nicholas E. Ford, *The Impact of Legal Entities on the Mechanics of Unitary Reporting*, in TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2007, at 118, 125 n.11 (PLI Tax Law & Estate Planning, Course Handbook Series No. J-770, 2007).

27. Pomp, *supra* note 11, at 53–54.

28. *Id.* at 54.

29. *Id.* Transactions between members of the group are usually eliminated from the computation of aggregate taxable income. *Id.*

determined, the next step is to determine how much of the income the company should apportion to the state. This amount is determined by multiplying the aggregate taxable income of the group by each member of the group's apportionment percentage.³⁰ Each member of the unitary group that has a nexus within the state is taxed on its share of the unitary income apportioned to the state.³¹

In contrast, states that do not use combined reporting, known as "[s]eparate entity states[,] treat related corporations as if they were unrelated strangers."³² This is true even with subsidiaries and their parent companies. The income and factors of the parent and the subsidiary have absolutely no effect on the tax calculations of the other.³³ Therefore, when a corporation has a subsidiary located outside of the state that does not directly conduct business within the state, the state will not be able to collect taxes from the subsidiary even if the parent handles all the assets of the subsidiary.

Doubts about combined reporting's constitutionality were eliminated by the United States Supreme Court when it upheld the use of combined reporting twice in the last twenty-five years, first in 1983³⁴ and again in 1994.³⁵ In the first case, *Container Corp. of America v. Franchise Tax Board*, the Court held that California's method of combined reporting did not violate the United States Constitution.³⁶ Container Corp., a Delaware corporation headquartered in Illinois, claimed California's use of the unitary business/formula apportionment method—another way of saying combined reporting³⁷—in the taxing scheme violated the Due Process and Commerce Clauses of the Constitution.³⁸ The Court disagreed, stating that while "a State may not, when imposing an income-based tax, 'tax value earned outside its borders,'" figuring out the exact "territorial allocation[]" of that value is difficult.³⁹ Therefore, the Court concluded that each state may enforce its

30. *Id.* Apportionment percentage is determined by performing the apportionment formula for each corporation in the group. *Id.*

31. *Id.*

32. *Id.* at 53.

33. *Id.*

34. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

35. *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994).

36. *Container Corp.*, 463 U.S. at 184.

37. Combined reporting is a simpler way of describing the unitary business and formula apportionment methods described in *Container Corp.* *Id.* at 165. The unitary business half of the equation describes the process of defining the scope of the unitary business, and the formula apportionment half describes the process of apportioning the income of the unitary business to the taxing state. *Id.*

38. *Id.* at 162.

39. *Id.* at 164.

own tax scheme, and the taxpayer must prove that the tax scheme results in “extraterritorial values being taxed.”⁴⁰

In addition, the Court laid out the requirements for a constitutionally valid state taxing scheme that attempts to tax interstate businesses. First, there must be a nexus between the taxing state and the interstate activities that gives rise to the tax at issue.⁴¹ Additionally, there must be “a rational relationship between the income attributed to the State and the intrastate values of the enterprise.”⁴² On the formula apportionment side, the first requirement is that the apportionment formula be fair under the Due Process and Commerce Clauses of the United States Constitution.⁴³ Fairness has two components: internal consistency and external consistency.⁴⁴ Internal consistency requires that, if the formula were applied in every jurisdiction, the unitary business would be taxed on all of its income but no more.⁴⁵ External consistency requires that the “factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.”⁴⁶ The final requirement is that, in addition to being fair, the apportionment formula must not violate the Commerce Clause by discriminating against interstate or foreign commerce.⁴⁷ If a state taxing scheme does not violate any of these requirements, it should be immune to constitutional challenge.

However, the Court’s decision in *Container Corp.* did not end the constitutional challenges to combined reporting. California’s system was challenged yet again in *Barclays Bank PLC v. Franchise Tax Board of California*,⁴⁸ but this time it was the application of the system to foreign-based companies that brought scrutiny under the Commerce Clause. Barclays Bank, a United Kingdom corporation, challenged California’s use of combined reporting to tax income attributed to Barclays within the state, arguing that the system “burdens foreign-based multinationals and results in double international taxation.”⁴⁹ Once more the Court rejected the constitutional challenge, holding that “the Constitution does not impede application of California’s corporate franchise tax to Barclays.”⁵⁰ Again, the Court stated

40. *Id.* (quoting *Exxon Corp. v. Wis. Dep’t of Rev.*, 447 U.S. 207, 221 (1980)).

41. *Id.* at 165–66. In short, nexus requires that there is a “minimal connection . . . between the interstate activities and the taxing State.” *Id.* (quoting *Exxon Corp.*, 447 U.S. at 219–20).

42. *Id.* at 166 (quoting *Exxon Corp.*, 447 U.S. at 219–20).

43. *Id.* at 169.

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.* at 170.

48. 512 U.S. 298 (1994).

49. *Id.* at 302.

50. *Id.* at 303.

that to be deemed violative of the Commerce Clause the taxpayer must show that the tax applies to activity lacking a substantial nexus to the taxing state, is not fairly apportioned, discriminates against interstate commerce, or is not fairly related to services provided by the state.⁵¹

Twenty-two states currently have combined reporting systems in place, six of which have been enacted within the past five years.⁵² As a recent report by the Center on Budget and Policy Priorities states, “[a] major reason for states’ growing interest [in combined reporting] is their recognition of how badly corporate tax shelters that exploit the lack of combined reporting are eroding state corporate tax payments.”⁵³ The report extols the virtues of using combined reporting to eliminate certain state corporate tax shelters, like the real estate investment trust (REIT) strategy used by Wal-Mart and the passive investment company (PIC) loophole used by Wisconsin banks.⁵⁴

B. Tax Avoidance Strategies in Wisconsin

Among the many tax shelters used by corporations today, three of the most common involve the creation of subsidiaries that are exempt from corporate income tax in the state of formation.⁵⁵ These three types are PICs, REITs, and captive insurance companies.⁵⁶ Corporations use these shelters either to shift taxable profits to the subsidiary or to stash income-earning assets.⁵⁷ Combined reporting could nullify all three tax shelters, as well as others.⁵⁸ However, while combined reporting would effectively eliminate many tax shelters at use today, it would not stop the lawyers and accountants working with these corporations from coming up with new inventive ways to avoid taxes. Fortunately, combined reporting *would* make it more difficult to develop tax avoidance schemes and would leave fewer loopholes to be exploited.

In the past decade, Wisconsin has attempted to put an end to two tax shelters—REITs and PICs. The most recent of the two attacks—Wal-Mart’s

51. *Id.* at 310–11. These four criteria of state tax Commerce Clause scrutiny were first developed in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), and together they are known as the *Complete Auto* four-prong test. See Christopher R. Grissom et al., *Challenges to Addback Statutes: Will the Statutes Survive?*, 46 ST. TAX NOTES 757, 775 (2007).

52. See MAZEROV, *supra* note 26, at 1; NACKER, *supra* note 26, at 5 tbl.1.

53. MAZEROV, *supra* note 26, at 1.

54. *Id.* at 2; see discussion *infra* Part II.B.

55. MAZEROV, *supra* note 26, at 2.

56. *Id.*

57. *Id.* at 2–3.

58. *Id.* at 3–5. Combined reporting would also nullify the transfer pricing and nexus isolation loopholes. See *infra* notes 169–70 and accompanying text.

use of the REIT—will be discussed first, followed by the PIC strategy used by Wisconsin banks.

1. Wal-Mart and the REIT

Wal-Mart uses REITs⁵⁹ as a way to avoid paying the full amount of corporate income taxes it would otherwise be required to pay. Since 1996, Wal-Mart has structured its operations in twenty-seven states as follows: one subsidiary, Wal-Mart Real Estate Business Trust, a REIT, is set up to manage the land that the stores sit on, and one subsidiary, Wal-Mart Stores, Inc., is set up to manage the stores themselves.⁶⁰ The store management subsidiary pays rent to the REIT subsidiary for the land the stores sit on and deducts the amount of the rent from its taxable income as a business expense.⁶¹ Setting high rent payments leaves Wal-Mart Stores, Inc. with “little to no profit on which state taxes ha[ve] to be paid.”⁶² This technique works because Wisconsin’s tax laws call for separate reporting—all companies file separate returns, even if a single parent owns multiple subsidiaries. Under combined reporting, both subsidiaries would be included on the return filed by their parent company; shifting money among subsidiaries would no longer be an option.

In response, two separate parts of Wisconsin’s government took action.⁶³ First, the state legislature got involved. Effective for tax years beginning January 1, 2008, Wisconsin now requires that certain amounts deducted or excluded from gross income for federal tax purposes—specifically, interest and rent expenses that are paid, accrued, or incurred to one or more related entities—must be “added back” before determining net income for Wisconsin tax purposes.⁶⁴

59. Real estate investment trusts will be discussed in more detail *infra*.

60. INST. FOR WIS.’S FUTURE, *supra* note 9, at 13–14.

61. Walters & Lank, *supra* note 2.

62. INST. FOR WIS.’S FUTURE, *supra* note 9, at 14.

63. See Walters & Lank, *supra* note 2. While the Department of Revenue’s case against Wal-Mart has brought these issues to the surface yet again, Wal-Mart is not the only company the state is concerned about. “[T]hree of the largest corporations in the U.S.—Microsoft, Merck & Co. and Sears Holdings, owner of Kmart and Lands’ End—paid no corporate income taxes in Wisconsin in 2005.” Mike Ivey, *Pols Go After Tax Dodgers; Bill Aims to Plug Corporate Loopholes*, CAPITAL TIMES (Madison, Wis.), Dec. 19, 2007, at A1.

64. WIS. STAT. § 71.26(2) (2007–2008); Edward Sakurai, *Continued Trend Toward State Related-Party Expense Addback*, 39 TAX ADVISER 807, 807 (2008). The “addback statute,” as it is commonly referred to, will be discussed in more detail *infra* Part III.B. Additionally, Senator Dave Hansen (D-Green Bay) introduced the Corporate Tax Accountability Act to the Wisconsin Legislature in December 2007. S.B. 367, 98th Leg., Reg. Sess. (Wis. 2007); see also discussion *infra* Part III.B.

Second, the Department of Revenue brought a case against Wal-Mart, Inc. before the Wisconsin Tax Appeals Commission to recover \$17.7 million in back corporate taxes, interest, and penalties from 1998 to 2000.⁶⁵ Department lawyer Mark Zimmer believes that Wal-Mart is not paying its fair share for the Wisconsin resources it utilizes in operating its stores.⁶⁶ Instead, Wal-Mart shifts the burden “to individuals and small businesses who are unable to set up such elaborate mechanisms.”⁶⁷

Since REITs are complicated structures, some explanation of their formation and tax attributes may be helpful. A REIT is a pass-through entity used for holding real estate.⁶⁸ Created by Section 856 of Title 26 of the United States Code, a REIT may qualify for special tax treatment under the Internal Revenue Code as a common law business trust, a corporation, or any other association that is taxable as a corporation.⁶⁹ Regardless of the chosen business entity, REITs are taxed as domestic corporations under Subchapter C of the Internal Revenue Code.⁷⁰

There are four major types of REITs being used in America today: equity trusts, mortgage trusts, hybrid trusts, and finite life trusts.⁷¹ Equity trusts are typically organized as “blind pools” for investing in several unidentified rental properties held for an indefinite period of time for the purpose of producing income from rents that are then distributable to shareholders as dividends.⁷² The Wal-Mart version of the REIT is slightly different. Instead of investing

65. See Walters & Lank, *supra* note 2.

66. *Id.*

67. *Id.*

68. See WILLIAM A. KELLEY, JR., REAL ESTATE INVESTMENT TRUSTS HANDBOOK 22 (2d ed. 1998). A pass-through entity is a non-taxable entity, such as a partnership, limited liability company, or Subchapter-S Corporation, where the entity computes its taxable income and then passes that income on to its owners as distributive shares. See HOWARD E. ABRAMS, FEDERAL INCOME TAXATION OF PARTNERSHIPS AND OTHER PASS-THRU ENTITIES 9 (1993). The owners of the entity are responsible for the taxes due on the entity's earnings, i.e., the tax burden is “passed-through” to the owners. See, e.g., 26 U.S.C. § 701 (2006) (“A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.”).

69. 26 U.S.C. § 856 (2006); see KELLEY, *supra* note 68, at 22.

70. 26 U.S.C. §§ 301–385 (2006).

71. KELLEY, *supra* note 68, at 8–11.

72. *Id.* For comparison purposes, the mortgage trust is similar to the equity trust but, instead of holding real estate, the trust is organized for “investing the proceeds from the sale of their shares in mortgages secured by real property, or mortgage-backed pass-through certificates.” *Id.* at 9. Hybrid trusts are organized for investing in a combination of equity properties and mortgages. *Id.* at 10. Finite life trusts became popular in the late 1970s and early 1980s as a response to a weak market for REIT shares. *Id.* at 11. Investors were interested in seeing a return on their investment during their lifetime. The difference between an equity trust and a finite life trust is the duration of the investment. Finite life trusts are organized to acquire property for a pre-determined amount of time—typically four to fifteen years—after which the properties are liquidated and the proceeds distributed to the shareholders. *Id.*

in unidentified rental properties, Wal-Mart's REITs are organized for the acquisition of specific properties—the property on which the Wal-Mart store sits.⁷³

To qualify as a REIT, and therefore qualify for a tax deduction for dividends paid to shareholders,⁷⁴ an organization must meet Internal Revenue Code qualifications relating to status, income, and investment.⁷⁵ Among the many requirements for forming and operating a REIT, two elements of specific relevance are the requirements that the REIT must have at least 100 investors and that it must pay out at least ninety percent of its annual earnings to investors as dividends.⁷⁶ In the federal tax system, those dividends are taxable due to an act of Congress that “made dividend payments from REITs to other corporations *ineligible* for the ‘dividends-received deduction,’ which effectively exempts most dividends paid from one corporation to another from the federal corporate income tax.”⁷⁷ The REIT loophole utilized by Wal-Mart in Wisconsin and elsewhere was created when states failed to follow in Congress's footsteps.⁷⁸ The result: income earned by REITs is completely untaxed in many states.⁷⁹

Wisconsin is not the only state that has been affected by Wal-Mart's tax avoidance strategies. According to Standard & Poor's Compustat, Wal-Mart has paid, on average, only half of the statutory state tax rates during the past decade, and the REIT strategy alone cut its state taxes by around twenty percent over one four-year period.⁸⁰ In response, several states have tried or are trying to put an end to the REIT loophole's use.⁸¹

In a well-publicized battle between Wal-Mart and the state of North Carolina,⁸² the state is attempting to put an end to Wal-Mart's REIT structure, calling the strategy an attempt to “distort [the company's] true net

73. See Drucker, *supra* note 5.

74. KELLEY, *supra* note 68, at 11.

75. 26 U.S.C. § 856(c) (2006).

76. 26 U.S.C. § 856(a); MAZEROV, *supra* note 26, at 11.

77. 26 U.S.C. § 243(d)(3) (2006); MAZEROV, *supra* note 26, at 12.

78. See MAZEROV, *supra* note 26, at 12. Wisconsin has effectively closed this loophole with the addback statute that will be discussed in more detail *infra* Part III.B.

79. *Id.* at 12.

80. See Drucker, *supra* note 5 (alteration in original).

81. Jack Wood, *Wal-Mart's Tax Shelter Room*, NEWSTEX WEB BLOGS, Oct. 23, 2007. Since the Drucker article appeared in the *Wall Street Journal* in February, six states—including Illinois, Maryland, New York, and Rhode Island—“have passed laws attempting to prohibit the maneuver.” *Id.*

82. David Ranii, *Wal-Mart Suit Plows Ahead*, NEWS & OBSERVER (Raleigh, N.C.), Nov. 1, 2007, at D3. The case was thrust into the national spotlight in February 2007 by Drucker's *Wall Street Journal* article, *supra* note 5.

income.”⁸³ In 2005, North Carolina ordered Wal-Mart to pay \$33 million in back taxes.⁸⁴ The company paid the bill but turned around and sued the state for a \$30.2 million tax refund, accusing the state of “improperly assessing its corporate income tax bill.”⁸⁵ Following an audit, the North Carolina Department of Revenue determined that the company’s tax return did not “disclose [its] true earnings” and forced it to file a single consolidated return.⁸⁶ The state then calculated an overall tax bill based on all of Wal-Mart’s North Carolina stores, including its Sam’s Club locations as well as its REITs.⁸⁷ Wal-Mart claims that this method of tax calculation violates the Due Process and Commerce Clauses of the U.S. Constitution by determining taxable income “in an arbitrary manner, without the guidance of any constitutionally acceptable standard.”⁸⁸ Consistent with prior Supreme Court holdings, the Wake County judge did not agree and rejected Wal-Mart’s claim.⁸⁹ Wal-Mart has appealed the ruling.⁹⁰

Unfortunately, Wal-Mart is not the only company using the REIT loophole to its advantage. According to the *Wall Street Journal*, “[s]tate authorities have had mixed records so far in pursuing back taxes and penalties in [REIT] cases.”⁹¹ AutoZone has been pursued by two separate states regarding its use of the REIT structure, winning the right to continue deducting the dividends in Kentucky but losing the preliminary round in its battle with Louisiana.⁹² Also, Massachusetts battled two recent acquisitions of Bank of America—Fleet Funding and Bank Boston Corp.—over their REIT structure, and Hawaii and Alabama have also engaged in litigation regarding REITs used within their states.⁹³ However, it is unknown how many battles states have fought over the use of REITs to lessen a company’s corporate tax burden “because such tax disputes are generally not disclosed

83. Drucker, *supra* note 5 (quoting filings from the case).

84. *Id.*

85. Ranii, *supra* note 82.

86. *Id.* (alteration in original) (internal quotation marks omitted).

87. *See id.*

88. *Id.* (internal quotation marks omitted).

89. David Ranii, *Judge Denies Giant Tax Refund*, NEWS & OBSERVER (Raleigh, N.C.), Jan. 5, 2008, at D1. In response to the ruling, Department of Revenue spokeswoman Kim Brooks stated that it is not “just a victory for the Department of Revenue, it is really a victory for every North Carolina taxpayer.” *Id.*

90. Staff Reports, *Wal-Mart to Appeal Tax Refund Ruling*, NEWS & OBSERVER (Raleigh, N.C.), Feb. 5, 2008, at D2.

91. Drucker, *supra* note 5.

92. *Id.*

93. *Id.*

unless lawsuits are publicly filed or the company reveals them in [Security Exchange Commission] filings.”⁹⁴

2. Wisconsin Banks and the PIC

Since early in this decade, the Wisconsin Department of Revenue has been engaged in an ongoing battle with state banks using another type of tax shelter—the PIC.⁹⁵ Wisconsin banks set up subsidiaries to hold their investment assets in states that have no corporate income tax, such as Nevada or Delaware.⁹⁶ In doing so, the banks transfer investment income that would otherwise be taxable in Wisconsin to places where it is not, thereby avoiding paying taxes on the assets.⁹⁷ This loophole exists in many non-combined reporting states and results in many corporations getting away with paying little or no corporate tax in the state where they conduct their business.⁹⁸ Collections from Wisconsin banks declined by more than 55% from 1996 to 2000—from \$39.2 million to \$17.3 million, a decline that was at least partially attributable to the increased use of this loophole.⁹⁹

In 2003, the Department of Revenue stepped in and tried to put an end to the loophole.¹⁰⁰ The state has settled with at least 180 banks—slightly more than half of the banks doing business in Wisconsin—and has collected around \$42 million in back-tax payments.¹⁰¹ However, some banks are still challenging Wisconsin’s authority to tax their Nevada PICs.¹⁰² Opponents of Wisconsin’s loophole-plugging strategy for combating the banks’ tax-avoidance strategy worry that “a state defeat in a single court case could undo all those settlements, at least with respect to future tax years.”¹⁰³ Regardless of whether such a concern is justified, simply plugging loopholes is not guaranteed to put an end to the problem in the long run.

Another version of the PIC strategy is the intangible holding company or trademark holding company loophole, where corporations transfer intangible assets that make money outside of the company to subsidiaries in non-

94. *Id.*

95. *See, e.g.*, Mike Ivey, *State Banks Can Keep Subsidiaries*, CAPITAL TIMES (Madison, Wis.), Sept. 16, 2004, at 1E.

96. *See id.*

97. *Id.*

98. *See, e.g.*, Sheldon H. Laskin, *Only a Name? Trademark Royalties, Nexus, and Taxing That Which Enriches*, 22 AKRON TAX J. 1, 5 (2007).

99. Mike Ivey, *Even Small Banks Follow the Leaders; They Set Up Shell Subsidiaries in No-Tax States, Series: Wisconsin Taxes Who Really Pays?*, CAPITAL TIMES (Madison, Wis.), May 14, 2003, at 7A; *see also* MAZEROV, *supra* note 26, at 10.

100. Ivey, *supra* note 95.

101. MAZEROV, *supra* note 26, at 10–11.

102. *Id.* at 11.

103. *Id.*

combined reporting states or states with no corporate income tax altogether.¹⁰⁴ A 2002 *Wall Street Journal* article highlighted the use of the loophole by corporations across the country whereby they transfer their trademarks to the subsidiary holding company and then pay “huge fees for use of the brand names.”¹⁰⁵ Those royalty fees are then deducted from state income to reduce the company’s tax liability.¹⁰⁶

Of the almost fifty corporations identified by the article, one of special significance to the Wisconsin Department of Revenue was Kohl’s.¹⁰⁷ The same year the article was published, the Department sought “\$800,000 in back taxes” from Kohl’s for the tax years 1994 to 1996.¹⁰⁸ The case was settled out of court in 2003 so it is uncertain how much Wisconsin was ultimately able to collect; Kohl’s tax payments in subsequent years have also been kept secret, so it is unknown what effect the litigation had on Kohl’s use of the holding company loophole.¹⁰⁹

Although the use of many of these specific loopholes by these specific companies has been shut down by the Department of Revenue’s targeted litigation over the past decade, future use of these and similar tax avoidance strategies is likely. The only proven way to eliminate their use is to adopt combined reporting. Opponents of combined reporting worry that a state tax structure requiring corporations to pay more in state and local taxes each year will counteract the already daunting task of luring corporations to Wisconsin.¹¹⁰ However, requiring corporations to pay their fair share for valuable state-sponsored resources will actually help the business climate by increasing the revenues that pay for those resources.

104. *Id.* at 9. The most notable use of the intangible holding company strategy is Toys R Us’s use of a holding company to hold and license the use of its trademarks and trade names. *See* *Geoffrey, Inc. v. S.C. Tax Comm’n*, 437 S.E.2d 13, 15 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993). The *Geoffrey* court concluded that “by licensing intangibles for use in [South Carolina] and deriving income from their use [in South Carolina], Geoffrey [had] a ‘substantial nexus’ with South Carolina.” *Id.* at 18; *see also* Cory D. Olson, *Follow the Giraffe’s Lead—Lanco, Inc. v. Director, Division of Taxation Gets Lost in the Quagmire that Is State Taxation*, 6 MINN. J.L. SCI. & TECH. 789, 804–05 (2005).

105. Glenn R. Simpson, *Diminishing Returns: A Tax Maneuver In Delaware Puts Squeeze on States—Trademark-Holding Companies Help Limited, Many Others Save Millions of Dollars—One Address for 670 Firms*, WALL ST. J., Aug. 9, 2002, at A1.

106. *Id.*

107. *Id.* For a complete list of the companies discovered by the *Wall Street Journal* to be using this form of tax avoidance, see MAZEROV, *supra* note 26, at 7.

108. Mike Ivey, *State Takes Kohl’s Corp. to Court in Pivotal Tax Case, Series: Wisconsin Taxes Who Really Pays?*, CAPITAL TIMES (Madison, Wis.), May 14, 2003, at 7A.

109. *See* INST. FOR WIS.’S FUTURE, *supra* note 9, at 15.

110. *See, e.g.,* NACKER, *supra* note 26, 9–10; Jeff Schoepke, Wis. Mfrs. & Commerce, *Insight: A National View of Wisconsin’s Business Tax Climate* (2007), <http://www.wmc.org/printdisplay.cfm?ID=1904>; Sen. Dave Schultz, *Our Public Policy Must Back Up Our Goals* (Apr. 27, 2007), <http://www.legis.wi.gov/senate/sen17/news/Press/2007/col2007-002.asp>.

C. *Wisconsin's Business Climate*

Business climate is typically defined as a combination of factors relating to the investment potential of a certain location.¹¹¹ These factors include:

(1) the quality and availability of the social and physical infrastructure that are the building blocks of successful economies; (2) measures of how strong the economy is and how well it provides opportunities for employment, profits, and an improving quality of life; (3) tax and fiscal measures, which indicate the extent to which individuals and companies are taxed and how those funds are used to grow the economy; and (4) indicators of an area's reputation in the business community for being accommodating and responsive to the needs of business.¹¹²

Among the many arguments against higher taxes, proponents of the contention that taxes are damaging to the business climate maintain that lower taxes are good for economic growth because of the image they create regarding the state's support of business interests.¹¹³ However, business decision makers are not likely to base such important decisions on a perception of what a certain state does or does not support. They are more likely to evaluate the entire cost-of-doing-business picture in addition to the availability of valuable public services and a skilled workforce.¹¹⁴

It is no secret that Wisconsin's business climate could use improvement.¹¹⁵ When the Tax Foundation released its 2009 State Business Tax Climate Index in October 2008, Wisconsin was ranked thirty-eight, up one spot from the 2008 rankings but still only two spots away from being in

111. Robert G. Lynch, *Weaknesses in the Common Arguments for State and Local Tax Cuts and Incentives*, 32 ST. TAX NOTES 597, 601 (2004).

112. *Id.*

113. See Pomp, *supra* note 11, at 59–60. Pomp notes that opponents of combined reporting often “cloak themselves with the banner of economic development” by arguing that combined reporting will hurt Wisconsin's business climate by “chas[ing] businesses out of the state, discourag[ing] new ones from coming to Wisconsin, and reduc[ing] jobs.” *Id.* at 60.

114. *Id.* at 61. Pomp lists ten reasons why legislators should not listen to arguments that link changes in the tax system that are opposed by business to poor economic development. *Id.* at 61–66. Specifically, Pomp notes that “innumerable factors are important to a business in its decision about where to locate,” including “quality and cost of labor, proximity to markets, . . . the level and quality of public services, and the range of other amenities that enter into the general quality of life offered.” *Id.* at 61–63.

115. See, e.g., JOSHUA BARRO, TAX FOUND., BACKGROUND PAPER: 2009 STATE BUSINESS TAX CLIMATE INDEX 3 tbl.1 (2008), available at <http://www.taxfoundation.org/files/bp58.pdf>; David Brunori, *Does the State Tax Climate Really Matter?*, 39 ST. TAX NOTES 887, 887 (2006).

the bottom ten.¹¹⁶ Wisconsin also moved from thirty-two to twenty-nine on the Corporate Tax Index between 2007 and 2009.¹¹⁷ Nothing to be proud of, but a low ranking on such a list does not guarantee that businesses will not want to locate within Wisconsin's borders.¹¹⁸

Tax is not the only consideration businesses make when deciding where to locate.¹¹⁹ "[S]tate spending on infrastructure and education" may also have a "positive effect on business activity."¹²⁰ Furthermore, there are at least a dozen different business climate indexes that all utilize different criteria and evaluation methods in their analysis, and Wisconsin's ranking on each index varies.¹²¹ For example, Wisconsin has been ranked as high as sixteenth on the Beacon Hill Institute's 2005 Metro Area and State Competitiveness Report,¹²² but on *Site Selection* magazine's recent ranking of United States business climates, Wisconsin was not listed among the states placing in the top twenty-five.¹²³

116. BARRO, *supra* note 115, at 3 tbl.1.

117. *Id.* at 12 tbl.3. The five major components that make up the Tax Foundation's State Business Tax Climate Index, with Wisconsin's 2008 ranking in parentheses, are corporate tax (29th), individual income tax (44th), sales tax (18th), unemployment insurance tax (25th), and property tax (31st). *Id.* at 9 tbl.2.

118. For example, *Forbes* magazine recently ranked Milwaukee as one of the top ten up-and-coming cities for technology companies. William Pentland, *Top 10 Up-And-Coming Tech Cities*, FORBES, Mar. 10, 2008, http://www.forbes.com/2008/03/10/columbus-milwaukee-houston-ent-tech-cx_wp_0310smallbizoutlooktechcity.html. In addition, *Forbes* recently ranked Madison, Wisconsin, as the number one city for job growth in 2009. Tara Weiss, *Ten Cities for Job Growth in 2009*, FORBES, Jan. 5, 2009, http://www.forbes.com/leadership/2009/01/05/cities-jobs-employment-leadership-careers-cx_tw_0105cities.html.

119. Brunori, *supra* note 115, at 887–88.

120. *Id.* at 888.

121. See generally GEORGE BITTLINGMAYER ET AL., KANSAS, INC. BUSINESS CLIMATE INDEXES: WHICH WORK, WHICH DON'T, AND WHAT CAN THEY SAY ABOUT THE KANSAS ECONOMY? 5, 19–21 tbl.1 (2005), available at <http://www.kansasinc.org/pubs/working/Business%20Climate%20Indexes.pdf> (providing information regarding each index).

122. BEACON HILL INST., METRO AREA AND STATE COMPETITIVENESS REPORT 2005, at 68, available at <http://www.beaconhill.org/Compete05/FinalCompete05-060921.pdf>. Additionally, Milwaukee was ranked twenty-fifth out of fifty metropolitan areas. *Id.* at 96. The Beacon Hill study measures competitiveness by studying eight indicators of the quality of the business environment: government and fiscal policies; security; infrastructure; human resources; technology; business incubation; openness; and environmental policy. *Id.* at 9–10.

123. Mark Arend & Adam Bruns, *Force Field*, SITE SELECTION, Nov. 2007, at 879. The *Site Selection* ranking is developed based on surveys of corporate real estate decision makers and actual project activity. *Id.* According to *Site Selection's* survey of corporate real estate executives, the state and local tax scheme of a location ranked as the third most important factor involved in location decisions. *Id.* at 915. The availability of incentives and flexibility of incentives programs came in at fifth and eighth, respectively. *Id.* The top two spots went to the availability of desired workforce skills and the ease of permitting and regulatory procedures. *Id.* Based on this survey, it seems that, while tax is a very important consideration, it is not the most important.

Furthermore, it has been argued that “state and local taxes are not typically a significant cost of doing business.”¹²⁴ According to a 2004 *State Tax Notes* article by Robert G. Lynch, state and local taxes are only a small piece of the business costs pie, and they “reduce profits only to a limited extent.”¹²⁵ Increasingly, corporations are looking to quality of life factors for choosing where to locate, including schools, safety, transportation, and other cultural aspects that will help draw top-quality employees.¹²⁶ “Businesses need to know that they can rely on high-quality, well-administered public services to facilitate the conduct of their enterprises.”¹²⁷

Instead of focusing on the potential hit Wisconsin’s business climate might take if corporations are required to account for all income attributable to Wisconsin, perhaps a better focus is on what nontax-related steps Wisconsin can take to better its business climate. According to the recent report by the Institute for Wisconsin’s Future, many of the public services that businesses value when making location decisions are facing budget shortfalls.¹²⁸ The main reason for the reduction and/or elimination of many of these vital services is the absence of adequate state aid.¹²⁹

Corporate tax revenue is an important and significant contributor to the funding of valuable state and local programs. Ernst & Young’s annual review of state and local business taxes estimates that Wisconsin businesses paid 35% of all state taxes collected and 47% of all local taxes.¹³⁰ However, the United States’ averages are 40% and 52%, respectively.¹³¹ If Wisconsin corporations paid at the same level as the national average, they would pay an additional \$800 million each year.¹³² “As a taxpaying partner in supporting state and local services, Wisconsin’s corporate sector ranks [forty-first] among all the states, according to Ernst & Young.”¹³³ Instead of corporations paying this amount, the burden of paying for valuable public services is passed on to individuals in the form of property and sales taxes. Adopting a system that requires corporations to pay their fair share, like combined

124. Lynch, *supra* note 111, at 597.

125. *Id.*

126. INST. FOR WIS.’S FUTURE, *supra* note 9, at 1.

127. Lynch, *supra* note 111, at 601.

128. INST. FOR WIS.’S FUTURE, *supra* note 9, at 3. Among the public systems the report lists as being in crisis are public schools (forced to cut staff and eliminate services offered to students), universities and technical colleges (raising tuition and cutting financial aid), fire safety and emergency medical services (personnel levels reduced), and programs designed to help people with disabilities (programs reduced or eliminated). *Id.*

129. *Id.*

130. *Id.* at 8–9.

131. *Id.* at 9.

132. *Id.*

133. *Id.*

reporting, would force corporations to help support the public services that they value.

III. THREE STRATEGIES FOR ATTACKING TAX AVOIDANCE LOOPHOLES

Wisconsin needs to make changes to its current tax strategy in order to reduce the diminishing amount of taxes collected from corporations doing business within its borders, as well as increase the revenues needed to reinvest in valuable public services that will increase economic growth and development and, hopefully, lead to an improved business climate. To achieve these goals, Wisconsin has a few options. First, it can continue its strategy of attacking tax avoidance strategies and loopholes as they become apparent. Second, it can adopt legislation aimed at stopping certain tax avoidance strategies. Third, it can adopt combined reporting.

A. *Attack Loopholes as They Become Apparent*

An alternative to adopting combined reporting, and a strategy used by Wisconsin, is to attack each tax avoidance strategy individually. Attacking tax avoidance strategies and loopholes as they become apparent can be an effective strategy, but only for stopping specific tax avoidance strategies. It does nothing to stop the other similar shelters that would be stopped with combined reporting. Additionally, attacking each shelter individually is a costly and time-consuming endeavor.¹³⁴

Further, a court decision or legislation blocking a certain loophole may be vulnerable to legal challenges in the future and may undo all the work that closed the loophole in the first place.¹³⁵ A properly drafted combined reporting system would not be so vulnerable, as the system's use has twice been upheld by the Supreme Court.¹³⁶ The best example of this strategy's apparent success—but more accurately described as its potential failure—is the PIC loophole plugged in 2003 and discussed earlier.¹³⁷ Similarly, even if the Department of Revenue wins a Tax Appeals Commission case against a company like Wal-Mart, there is no guarantee that it will be able to collect the taxes, and nothing will stop the company's creative accounting and legal professionals from inventing new, more elusive tax avoidance strategies.¹³⁸

134. Consider, for example, that each shelter attack has to go through the judicial process, complete with all the monetary and opportunity costs of litigation.

135. See *supra* Part II.B.2 for a discussion of Wisconsin's PIC litigation.

136. See *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 303 (1994); *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 184 (1983).

137. See discussion *supra* Part II.B.2.

138. And rightfully so. As Judge Learned Hand stated, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *Helvering v. Gregory*, 69

Wisconsin needs a more permanent plan that will bring in more revenue and stop these tax avoidance strategies across the board.

Additionally, this strategy does nothing to improve the business climate. It is the strategy that has been used in Wisconsin for many years, and—as various rankings and studies have shown—the Wisconsin business climate is lackluster at best.¹³⁹ Improving the business climate requires investing in public services and training a skilled workforce.¹⁴⁰ Spending valuable state resources attacking tax avoidance strategies through litigation does neither of these and is counterproductive to the goal of improving the business climate.

B. Adopt Targeted Legislation

Wisconsin policy makers have been working on ways to fix the state's corporate tax structure in a way that will reduce or eliminate the lost revenues from tax avoidance strategies employed by companies like Wal-Mart. Most significantly, the Wisconsin Legislature adopted a related-entity addback provision,¹⁴¹ which requires certain entities to add back interest and rental expenses paid to related entities that were deducted from taxable income at the federal level before determining taxable income at the state level.¹⁴² More importantly, the addback provision effectively closes the Wal-Mart REIT loophole.

Addback statutes similar to the one enacted in Wisconsin began to appear widely around the new millennium.¹⁴³ Although each state's statute differs slightly, the general purpose of each is the same: to cure the PIC and REIT loopholes by requiring companies to account for related-party transactions.¹⁴⁴ Most addback statutes require the addback of interest or royalty expenses

F.2d 809, 810 (2d Cir. 1934). As long as the loopholes exist, tax professionals should not be faulted for using them. However, combined reporting would close these loopholes.

139. See *supra* Part II.C.

140. See, e.g., Lynch, *supra* note 111, at 601.

141. WIS. STAT. § 71.26(2) (2007–2008), enacted by 2007 Wis. Act 226 § 70.

142. Memorandum from the Legislative Fiscal Bureau to the Members of the Comm. of Conference 19–22 (May 12, 2008), available at http://www.legis.state.wi.us/lfb/2007-09Bills/2008_05_12_cc.pdf. The provision applies to corporations, S-Corporations, partnerships, LLCs, individuals, fiduciaries, and insurance companies. Wis. Dep't of Rev., Addback of Related Party Interest and Rent Expenses (June 19, 2008), <http://www.revenue.wi.gov/taxpro/news/080619.pdf>.

143. Michigan was the first state to enact an addback statute in 1975. Christopher R. Grissom & Janette M. Lohman, *Challenges to Addback Statutes: Will the Statutes Survive?*, 46 ST. TAX NOTES 757, 760 (2007). Since then at least sixteen states, as well as the District of Columbia have done so, including Alabama, Arkansas, Connecticut, Georgia, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Mississippi, New Jersey, North Carolina, Ohio, Rhode Island, Tennessee, and Virginia. *Id.*

144. *Id.*

unless the transaction meets one or more exceptions.¹⁴⁵ Some of the common exceptions include:¹⁴⁶ situations where the taxpayer has entered a written agreement with the department responsible for tax collection to use an alternative apportionment method;¹⁴⁷ the adjustments are unreasonable;¹⁴⁸ and various versions of an exception if the taxpayer can prove that the payment was not made with the purpose of tax avoidance.¹⁴⁹

Wisconsin's addback provision has the same goals. As Governor Doyle put it, the addback statute "[c]loses an unacceptable tax loophole used by multinational corporations to shift profits out of the state to avoid paying Wisconsin taxes."¹⁵⁰ Specifically the provision states that "the amount deducted or excluded under the Internal Revenue Code for interest expenses and rental expenses that are directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related entities."¹⁵¹ Addback is not required under the following exceptions:

The amount is disclosed and:

1. The related party to which the taxpayer paid, accrued, or incurred the interest or rental expenses paid, accrued, or incurred such amounts to an unrelated party;
2. The related party was subject to tax on, or measured by, its net income in Wisconsin or any other state, U.S. possession, or foreign country, and the aggregate effective

145. *Id.*

146. See *id.* at 760–71 for a summation of the addback statutes in nineteen states and the District of Columbia.

147. See, e.g., ALA. CODE § 40-18-35(b)(2) (LexisNexis Supp. 2008).

148. See, e.g., *id.*

149. See, e.g., ALA. CODE § 40-18-35(b)(3) (LexisNexis Supp. 2008) (requiring that the related-party is not primarily engaged in managing, acquiring, or maintaining intangible property or related-party financing); ARK. CODE ANN. § 26-51-423(g)(1)(B)(i) (West Supp. 2008) (requiring that the related-party payment was an arms-length transaction); CONN. GEN. STAT. ANN. § 12-218c(c)(2)(A) (West 2008) (requiring that the related-party "during the same income year directly or indirectly paid, accrued or incurred such portion to a person who is not a related member").

150. Gov. Jim Doyle, *Governor's Veto Message*, WIS. ASSEMBLY J. 792, 793 (2008). The Governor also noted that he concurred with the Legislature's intent that the addback provision would not lead to corporations being taxed twice, and he requested that the Department of Revenue ensure that such intent be carried through in interpreting and enforcing the provision. See *id.* at 794.

151. WIS. STAT. § 71.26(2)(a)(7) (2007–2008). "Related entity" is defined by section 71.01(9am) of the Wisconsin Statutes as "any person related to a taxpayer as provided under section 267 or 1563 of the Internal Revenue Code . . . and any real estate investment trust under section 856 of the Internal Revenue Code, except a qualified real estate investment trust." *Id.* § 71.01(9am) (2007–2008).

tax rate applied to the income is at least 80% of the taxpayer's aggregate effective rate; or

3. The taxpayer establishes that the transaction has a business purpose other than the avoidance or reduction of tax, the transaction changed the taxpayer's economic position in a meaningful way apart from the tax effects, and the interest and/or rental expenses were paid at an arm's-length rate.¹⁵²

However, the provision only requires the addback of interest and rental payments—it does not require the addback of royalty payments.¹⁵³ Consequently, it does nothing to stop corporations from utilizing the intangible holding company loophole to avoid taxes on royalty income from intellectual property.¹⁵⁴

Additionally, there is some concern regarding whether the addback statutes will stand up against constitutional challenges. Specifically, it has been argued that corporate taxpayers may be able to defeat addback statutes because the addback requirement is actually a tax on the out-of-state related entity; the out-of-state related entity does not have taxable presence in the taxing state, and, therefore, the provision violates the Commerce and Due Process Clauses of the United States Constitution because it attempts to tax extraterritorial values.¹⁵⁵

As widespread use of addback provisions is a relatively recent trend, there have been only a few judicial challenges as of yet, and it is still unclear in whose favor the balance will weigh. In the first of such decisions, *VFJ Ventures, Inc. v. Surtees, Inc.*,¹⁵⁶ an Alabama circuit court found that VFJ Ventures did not have to add back royalty payments to two related-party intangible management companies because, under an Alabama statutory

152. *Id.* § 71.80(23) (2007–2008); see also Sakurai, *supra* note 64, at 807 (summarizing common exceptions to addback statutes).

153. Jamshed Patel, *Corporate Income Tax: Intangible Holding Companies*, LEXISNEXIS PRACTICE INSIGHTS (2008), available at Lexis WI Tax P.I. 4,160.

154. *Id.*

155. Philip M. Plant, *The Addback Statute Wars—The Taxpayers' Case*, 37 STATE TAX NOTES 585, 585–86 (2005); see also Grissom & Lohman, *supra* note 143 (highlighting the potential issues that may arise under the four prongs of the *Complete Auto* Commerce Clause analysis as well as the Foreign Commerce Clause and the Due Process Clause). But see Sheldon H. Laskin, *Contention on State Income Tax Addback Statutes is Based on a Misconception*, 27 ST. TAX NOTES 701 (2005) (responding to Plant's article and asserting that payments triggering addback statutes are sufficiently related to business income in the taxing state).

156. Montgomery County Circuit Court, No. CV-03-3172 (Ala. Jan. 24, 2007) (text of decision available in 2007 State Tax Notes 20-6).

exception, requiring VFJ Ventures to do so would be unreasonable.¹⁵⁷ In his decision, Judge McCooley stated that the payments were a necessary cost of doing business, and therefore, requiring VFJ Ventures to add back the payments would frustrate the purpose of the addback statute, which is to “prevent abusive deductions and to ensure that income fairly attributable to Alabama is taxed in Alabama.”¹⁵⁸

However, the Alabama Court of Civil Appeals overturned Judge McCooley’s decision, holding that the unreasonable exception applied only when the addback results in “taxation that is out of proportion to [the corporation’s] activities in [Alabama].”¹⁵⁹ The court agreed with the Alabama Department of Revenue’s interpretation of the unreasonableness exception as “not being determined by business purpose or economic substance.”¹⁶⁰ Consequently, VFJ Ventures was required to add back the royalty payments made to the related entities.¹⁶¹

Regardless of the results of such litigation in Wisconsin or other states, it seems that Wisconsin’s addback statute may not provide a sufficient response to the problems of corporate tax avoidance.¹⁶² In another legislative effort to solve the problem, Senator Dave Hansen (D-Green Bay) introduced the Corporate Tax Accountability Act in December 2007.¹⁶³ The Act was introduced in response to a report by the Milwaukee-based Institute for Wisconsin’s Future regarding corporate tax avoidance.¹⁶⁴ According to the

157. *Id.* at 5.

158. *Id.*

159. *Surtees v. VFJ Ventures, Inc.*, No. CV-03-3172, 2008 WL 344118, at *26 (Ala. Civ. App. Feb. 8, 2008), *aff’d sub. nom.; Ex parte VFJ Ventures, Inc.*, No. CV-03-3172, 2008 WL 4277998, at *1 (Ala. Sept. 19, 2008).

160. *VFJ Ventures, Inc.*, 2008 WL 344118, at *13.

161. *See id.* at *28.

162. It has been argued that addback statutes are the “second best solution” to addressing the problems of holding company tax avoidance. Mark J. Cowan & Clint Kakstys, *A Green Mountain Miracle and the Garden State Grab: Lessons From Vermont and New Jersey on State Corporate Tax Reform*, 60 TAX LAW. 351, 362 (2007), available at <http://www.wispolitics.com/1006/071219hansen.pdf> (internal quotation marks omitted). Specifically, Cowan and Kakstys argue that there are four problems with addback statutes: (1) they are “fairly easy to plan around”; (2) the exceptions “create litigation”; (3) they “do not address the shifting of income that occurs from the movement of assets to no-tax states”; and (4) “there may be constitutional issues.” *Id.* at 362–63.

163. S.B. 367, 98th Leg., Reg. Sess. (Wis. 2007); Press Release, Wis. Sen. Dave Hansen, Senator Hansen Introduces Corporate Tax Accountability Act (Dec. 20, 2007); Ivey, *supra* note 63. The proposed Act, however, was still in the possession of the Senate at the end of the general business floor period that adjourned on March 13, 2008. *Chief Clerk’s Entries*, WIS. SENATE J., Mar. 21, 2008, at 735. Accordingly, it failed to pass pursuant to Senate Joint Resolution 1 and was adversely disposed of on March 21, 2008. *Id.*

164. INST. FOR WIS.’S FUTURE, *supra* note 9, at 1.

report, uncollected corporate taxes cost Wisconsin \$643 million in 2006.¹⁶⁵ The Act was aimed at stopping what the report referred to as “corporate tax leakage”¹⁶⁶ by requiring corporations to disclose the following:

- Their bottom-line tax liability in the state, including any tax credits or exemptions that affect their income for tax reasons.
- Any subsidiaries and their existing relationships that may affect taxable income in Wisconsin.
- Information that would help identify other legal ways in which corporations reduce or avoid paying their fair share of state taxes.¹⁶⁷

While the addback statute and the proposed Corporate Tax Accountability Act are both a step in the right direction for Wisconsin, they may not answer the problems of increasing revenue collection and avoiding corporate use of tax avoidance strategies. The best method for accomplishing both goals is the adoption of a state tax strategy that utilizes combined reporting.

C. Adopt Combined Reporting

Combined reporting, as a state tax strategy, simply requires corporations to pay their fair share of state corporate income tax. In addition to eliminating the REIT loophole used by Wal-Mart, it would also eliminate any tax avoidance scheme that “shift[s] taxable profits into a tax-haven subsidiary” or “stash[es] corporate assets that earn income from outside the corporation.”¹⁶⁸ Additionally, combined reporting would be effective against other forms of tax avoidance, such as the strategies known as transfer pricing¹⁶⁹ and nexus

165. *Id.* at 6.

166. *Id.* at 1. The Institute for Wisconsin’s Future defines “corporate tax leakage” as “the loss of state corporate income tax due to large companies’ tax avoidance using tax breaks, loopholes and profit shelters.” *Id.*

167. Corporate Tax Accountability Act, S.B. 367, 98th Leg., Reg. Sess. (Wis. 2007); Press Release, Wis. Sen. Dave Hansen, *supra* note 163.

168. MAZEROV, *supra* note 26, at 2–3.

169. Transfer pricing occurs when a manufacturer corporation creates a subsidiary to control its distribution and sales activities within a state where its customers are located. *Id.* at 19. The price paid for the products by the distribution subsidiary to the manufacturing plant is known as the “transfer price.” *Id.* If both the plant and its distribution subsidiary are located in non-combined reporting states, the corporation may “set its transfer prices in a way that minimizes its total tax liability.” *Id.* To combat tax-motivated transfer pricing, almost every non-combined reporting state “allows its tax department to adjust transfer prices on a case-by-case basis to fairly reflect the income actually earned in the state.” *Id.* at 20. However, it is not practical for state tax departments to audit the millions of transactions that occur every year. *Id.* Combined reporting would eliminate the need to do so, as well as eliminate tax-motivated transfer pricing altogether. *See id.* at 20, 22.

isolation, where companies “‘wall-off’ as much of the corporation’s profit as possible in a subsidiary that is not taxable in the state(s) where the subsidiary’s customers are located.”¹⁷⁰

The myriad of benefits resulting from combined reporting can all be encapsulated by its two main advantages. First, combined reporting renders the tax planning techniques discussed in this Comment moot.¹⁷¹ Not only does this eliminate tax avoidance, but also it allows corporations to structure themselves in a way that is most advantageous to their operations instead of adopting a structure that is most advantageous to tax planning.¹⁷² Second, combined reporting guarantees accuracy and equality in tax collections.¹⁷³ By allowing the state to tax the value of the enterprise as a whole, including the value derived from synergies and “interdependencies that exist between related corporations,” combined reporting captures a more accurate level of the corporation’s earnings within the state.¹⁷⁴ Additionally, combined reporting lessens the burden on smaller intrastate entities that may not be fiscally able to take advantage of tax-avoidance strategies by ensuring that such companies do not “shoulder[] a disproportionate share of the tax burden.”¹⁷⁵

Two main arguments have been advanced in opposition to combined reporting. First, it has been argued that combined reporting as a system is too complex, and it will create expensive and needless litigation.¹⁷⁶ However, while combined reporting is a complex system and it may create a learning curve for some corporations, it is already being used in twenty-two states.¹⁷⁷ Many of the large interstate corporations that will be most affected by combined reporting, such as Wal-Mart, are already doing business in combined reporting states and will already be accustomed to its general principles and procedures. Specifically, Illinois and Minnesota have both been using combined reporting for over twenty years.¹⁷⁸

170. *Id.* at 3. Nexus isolation takes advantage of a federal law that limits the amount of income taxable to out-of-state corporations if the companies “limit their activities within the state to ‘solicitation of orders.’” *Id.* Combined reporting eliminates much of the benefit of nexus isolation by requiring any subsidiary the state has nexus over to calculate its tax based on the profits of the subsidiary’s entire corporate family. *Id.* at 4.

171. Cowan & Kakstys, *supra* note 162, at 366.

172. *Id.*

173. *Id.*

174. *Id.* at 367.

175. *Id.* at 366.

176. *Id.* at 368.

177. See NACKER, *supra* note 26, at 5 tbl.1.

178. *Id.*

Additionally, litigation regarding tax-avoidance techniques is already occurring, such as Wisconsin's battles with Wal-Mart and bank PICs.¹⁷⁹ Combined reporting will eliminate the necessity for litigation aimed at attacking tax loopholes. Although there is likely to be some litigation while corporations struggle with the State over what income must be included and which entities are part of the unitary business, the expense of such litigation may be offset by the reduction of other tax-avoidance litigation. Consequently, this argument is a wash.

The second argument against combined reporting is its potential effect on the business climate.¹⁸⁰ Opponents of combined reporting argue that combined reporting will cause corporations "to leave the state, discourage other businesses from entering the state, and result in the loss of jobs."¹⁸¹ However, this does not appear to be the case. Many of the states that have adopted combined reporting consistently rank higher on business climate rankings than Wisconsin.¹⁸² In fact, of the twenty-two states that currently have a combined reporting regime in place, fifteen were ranked higher than Wisconsin on the Tax Foundation's index.¹⁸³ Also, of the twelve states ranked lower than Wisconsin, five do not have combined reporting.¹⁸⁴ It seems that the corporate tax regime each state uses does not have a measurable impact on the state's business climate. Additionally, if a corporation wants to avoid combined reporting it would have to limit its operations to thirty states, excluding California, Texas, Illinois, and New York—all states with a considerable business presence.¹⁸⁵ It seems unlikely that a corporation will refuse to do business in a state simply because of the tax regime at work in that state.¹⁸⁶

Vermont is a good example of a state with what may be considered a poor business tax climate that recently adopted combined reporting. Vermont perennially ranks in the low- to mid-forties on the Tax Foundation's State

179. See *supra* Part II.B.

180. Cowan & Kakstys, *supra* note 162, at 368; Pomp, *supra* note 11, at 60.

181. Cowan & Kakstys, *supra* note 162, at 368.

182. See BARRO, *supra* note 115, at 3 tbl.1.

183. *Id.* Those states are: Alaska (4th), Montana (6th), Texas (7th), New Hampshire (8th), Oregon (9th), Utah (11th), Colorado (13th), Michigan (20th), Arizona (22nd), Illinois (23rd), Hawaii (24th), Idaho (29th), North Dakota (30th), Kansas (31st), and West Virginia (36th). *Id.*

184. *Id.* Those states are North Carolina (39th), Iowa (44th), Maryland (45th), Rhode Island (46th), and New Jersey (50th). *Id.*

185. See NACKER, *supra* note 26, at 5 tbl.1.

186. However, it must be noted that a state's corporate tax regime may have some effect on where companies choose to locate manufacturing and transportation operations, among other decisions. Consequently, Wisconsin must work on improving the other aspects of its business climate—such as availability of a skilled workforce, standard of living, education, etc.—in order to offset any concern that such companies may have.

Business Tax Climate Index.¹⁸⁷ In 2003, the year before Vermont adopted combined reporting, the state ranked forty-third.¹⁸⁸ In 2009, five years after adopting combined reporting, Vermont again is ranked forty-third.¹⁸⁹ While a low ranking is nothing to strive for, the fact that the state's business tax climate ranking has not moved dramatically since adopting combined reporting shows that adopting combined reporting will have little to no effect on how companies and tax practitioners view Wisconsin's corporate tax climate.

Vermont adopted its combined reporting law in 2004, the first state to do so in over twenty years.¹⁹⁰ The push toward combined reporting was the result of Governor James Douglas's call for a state tax regime that was "more fair and equitable for all."¹⁹¹ Accordingly, the Vermont legislature began crafting a combined reporting system in early 2004.¹⁹² As part of its efforts, the Vermont Department of Taxes presented the Vermont House Committee on Ways and Means with a comprehensive report on combined reporting.¹⁹³ The report estimated that Vermont lost between \$8.32 billion and \$12.38 billion annually due to the use of tax shelters and tax-avoidance strategies.¹⁹⁴ The Department also "estimated that the additional revenue generated from enacting mandatory combined reporting would be sufficient" to offset combining the tax regime with a one percent reduction in the state corporate income tax rate.¹⁹⁵

In addition, the Committee heard testimony from both those in favor of combined reporting and those against.¹⁹⁶ Among those in favor of combined reporting, Professor Richard Pomp testified that adopting combined reporting in conjunction with a reduction of the corporate tax rate was the right decision and one that he felt would improve the business climate in Vermont.¹⁹⁷ In response to the common business climate argument against combined

187. See BARRO, *supra* note 115, at 3 tbl.1.

188. Cowan & Kakstys, *supra* note 162, at 396.

189. *Id.*; BARRO, *supra* note 115, at 3 tbl.1.

190. VT. STAT. ANN. tit. 32, § 5832 (2008); Cowan & Kakstys, *supra* note 162, at 390; *see also* Emily Dagostino, *Is New Vermont Law a Sign of a Combined Reporting Comeback?*, 2004 ST. TAX TODAY, Sept. 24, 2004 (noting that combined reporting bills or amendments were introduced in seven other states in 2003 and 2004, which is the most legislative attention combined reporting has seen in twenty years).

191. Vt. Gov. James Douglas, *State-of-the-State Message*, J. JOINT ASSEMBLY 6 (Jan. 6, 2004), available at <http://www.leg.state.vt.us/docs/legdoc.cfm?URL=/docs/2004/journal/ja040106.htm>.

192. Cowan & Kakstys, *supra* note 162, at 392.

193. *Id.* at 392–93.

194. *Id.* at 393.

195. *Id.*

196. *Id.* at 399–405.

197. *Id.* at 400.

reporting, Professor Pomp urged Committee members not to let such arguments influence their decision, as “[business climate] can mean whatever you want it to mean.”¹⁹⁸ He went on to note that “combined reporting, and taxes in general, have very little impact on business decisions and economic growth. Businesses do consider taxes, but they weigh other factors—such as an educated workforce, infrastructure, labor costs—much more in deciding where to locate.”¹⁹⁹

In opposition to combined reporting, the Committee heard from two groups—Associated Industries of Vermont and the Council on State Taxation.²⁰⁰ Both groups focused their arguments on the traditional arguments against combined reporting: complexity and a weakening of the business climate.²⁰¹ The Committee, however, was not persuaded by the opposition arguments, as the Department, Professor Pomp, and the other arguments in favor had sufficiently addressed the limited arguments against combined reporting presented by the two groups.²⁰²

Consequently, combined reporting may have a positive effect on Wisconsin’s business climate, not a negative effect as is often assumed when one talks of increasing taxes paid by corporations. In reality, the actual effect of combined reporting is not an increase in taxes; it simply requires corporations to pay the taxes they should be paying in the first place. Any extra revenue collected by the state can then be put toward improving the business climate in Wisconsin through increased and enhanced public services and a betterment of the state in general.

IV. CONCLUSION

Adopting combined reporting is a necessary step for Wisconsin’s future. Although the business climate in Wisconsin could use improvement, allowing corporations to continue to shirk their share of the responsibility to pay for valuable public services is not a solution. Attacking tax avoidance loopholes

198. *Id.* (internal quotation marks omitted).

199. *Id.* (internal quotation marks omitted).

200. *Id.* at 401–02.

201. *Id.* at 402–05.

202. *Id.* at 405. While Vermont is an example of a state that enacted combined reporting despite concern over its effect on the business climate, Vermont’s law may be differentiated because of its concurrent reduction in the corporate tax rate. *Id.* at 408. Such a reduction most likely softened the blow for those traditionally against combined reporting, such as manufacturing groups and those with conservative tax views. As the Vermont Department of Taxes noted to the Vermont House Committee on Ways and Means, adopting combined reporting simply to raise revenues looks like “a revenue grab” and tends to be “a tough sell from a political standpoint.” *Id.* at 397. Indeed, the Committee “felt it had seized the high ground because it was using the revenue from combined reporting to reduce the corporate tax rate,” which insulated the Committee from anti-business charges. *Id.* at 405.

on a case-by-case basis is also not a good strategy, as each litigation costs the state money and does not guarantee success. Additionally, the related-entity addback provision recently added to the Wisconsin Statutes is a step in the right direction, but it will not stop all tax avoidance strategies currently at use in Wisconsin.

Combined reporting would eliminate the Wal-Mart REIT loophole, as well as the PIC, intangible holding company, and transfer pricing loopholes. In addition, it would nullify most of the other tax avoidance strategies currently used in Wisconsin today. Although combined reporting is not a perfect system, it is a better system. Once in place, a combined reporting system will guarantee that the task of “slicing [the] shadow”²⁰³ of corporate income will be a fair and just process that requires corporations doing business in Wisconsin to help pay for the resources they value. Therefore, Wisconsin should adopt combined reporting and use the additional revenue to help develop valuable public services, such as providing quality education and training for a skilled workforce, which will help draw corporations to this state.

STACI FLINCHBAUGH*

203. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 192 (1983).

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